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Research Update:

Hydro One Inc. Downgraded To 'A' From 'A+' Following Privatization Announcement; Outlook Stable

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Research Update:

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Overview

- We are downgrading our long-term corporate credit rating on Hydro One Inc. to 'A' from 'A+'.
- We are also revising our view on the likelihood of extraordinary government support from the Province of Ontario to "moderately high" from "high."
- In addition, we are affirming our 'A-1' short-term corporate credit and 'A-1(mid)' commercial paper ratings on Hydro One.
- The stable outlook reflects our view of the relatively stable regulatory regime that we believe contributes to predictable cash flows.

Rating Action

On April 20, 2015, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Hydro One Inc. to 'A' from 'A+'. The outlook is stable.

Standard & Poor's also revised its view of the likelihood of extraordinary support to "moderately high" from "high." These rating actions and revisions are in response to the Government of Ontario's announcement that it has a clear intention to immediately conduct an initial public offering of 15% of Hydro One and ultimately to sell up to 60%.

In addition, Standard & Poor's affirmed its 'A-1' short-term corporate credit rating and 'A-1 (mid)' commercial paper rating on the company.

Rationale

Hydro One is a government-related entity (GRE), as defined in our criteria, and as such we base our ratings on our assessment of the company's stand-alone credit profile (SACP) and our assessment of the likelihood that the province would provide timely and sufficient extraordinary support in the event of financial distress. To determine the likelihood of government support, we assess the strength and durability of the link and the role between the government and the company.

We believe that the strength and durability of the link between the government and the company have weakened with the government's announcement of its intention to privatize the majority of Hydro One. Accordingly, based on our criteria, we have revised our assessment of the link between the government and the company to "strong" from "very strong" (see "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015, on RatingsDirect). We continue to assess the role of the company to the government as "important." In addition, we have not changed our assessment of the 'a' SACP on the company. The sale of Hydro One Brampton Inc. is not material to this assessment.

Because of our revision to the link, we have changed our view of the likelihood of extraordinary support to "moderately high" from "high." Based on our criteria, given our rating on the Province of Ontario (AA-/Negative/A-1+) and our SACP on Hydro One of 'a', the highest corporate credit rating Hydro One can achieve is 'A', resulting in the one-notch downgrade. A further weakening in the likelihood of extraordinary support by Ontario will not result in a further lowering of the rating.

We have revised the outlook to stable based on the stable outlook of Hydro One's business and the fact that, under our government-related entity criteria, based on our rating on Ontario, a downgrade of Ontario would not affect the rating on Hydro One.

Based on a positive comparable rating analysis modifier, we raised the anchor one notch to arrive at the 'a' SACP. We believe that Hydro One is a strong operator of transmission and distribution in the face of a large and diverse geographic service area. Moreover, the company is the dominant player in Ontario and is further supported by very favorable regulation.

We believe there is a "moderately high" likelihood that its owner, the Province of Ontario, would provide timely and sufficient extraordinary support in the event of financial distress. This is based on "strong" link and "important" role as our GRE criteria define those terms. Based on a "moderately high" likelihood of extraordinary support there is no rating uplift to the SACP.

Liquidity

The short-term rating on Hydro One is 'A-1' and the company continues to have "adequate" liquidity, as our criteria define the term. We expect that liquidity sources will be adequate to cover uses more than 1.1x in the next 12 months. We expect that, in the event of a 10% EBITDA decline, Hydro One's sources of funds would still exceed its uses. In our view, the company has sound relationships with its banks and generally prudent financial risk management. We continue to believe that Hydro One would have considerable flexibility regarding dividend payments in a highly unexpected financial stress scenario, and therefore have not included it as a use of cash in our liquidity calculations.

Principle liquidity sources include:

- Projected funds from operations (FFO) of about C$1.5 million-C$1.7 billion

- C$1.5 billion of available committed credit facilities at Dec 31, 2014, expiring in June 2019

Principle liquidity uses include:
- Capital spending of about C$ 1.6 billion
- Debt maturities of about C$550 million within the next 12 months

Outlook

The stable outlook reflects our view of the relatively stable regulatory regime, which we believe contributes to predictable cash flows.

Downside scenario

We could lower the rating on Hydro One in the event of lower-than-expected cash flows and earnings resulting in adjusted FFO-to-debt below 10% on a consistent basis. In addition, although we don't expect it a material adverse regulatory ruling or market restructuring (such as the assumption of the obligation to supply, not just deliver, electricity) could lead us to remove the positive comparable rating modifier and lower our 'a' SACP.

A lowering of the rating on Ontario would not affect the rating on Hydro One.

Upside scenario

An improvement in the company's SACP is unlikely without the assurance of stronger cash flow interest and debt coverage ratios (such as higher than 20% AFFO-to-debt on a sustained basis, at the higher end of the "intermediate" financial risk profile), which we don't expect within the next two-to-three years.

Ratings Score Snapshot

Corporate Credit Rating: A/Stable/A-1

Business risk: Excellent
- Country risk: Very low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)

- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: a

- Likelihood of government support: Moderately high (no impact)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Criteria: Ratios and Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Lowered

	To	From
Hydro One Inc.		
Corporate credit rating	A/Stable/A-1	A+/Negative/A-1
Senior unsecured debt	A	A+

Ratings Affirmed

Hydro One Inc.	
Corporate credit rating (short term)	A-1
Commercial paper	A-1(mid)

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